Testimony of

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To the Committee on Financial Services
United States House of Representatives

Hearing on Legislative and Regulatory Options Regarding Mortgage Foreclosures

September 20, 2007

Mr. Chairman, Ranking Member Bachus and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago, and am a Past President of the International Union for Housing Finance. I have both experienced and studied many credit cycles, of which the housing and subprime mortgage boom and bust is the latest example.

To put the problems in context: The severe mortgage and housing industry problems we are experiencing can best be understood as the deflation of a classic asset bubble, the asset in this case of course being houses and condominiums. The boom is always marked by rapid and unsustainable price increases, inducing and in turn fueled by a credit overexpansion; the inevitable bust follows with defaults, losses and a credit contraction.

Possible political responses to the problems fall into two categories:

First, in addition to monetary policy, temporary programs to bridge and partially offset the impact of the bust, and to reduce the risk of a housing sector debt deflation. I will consider some of these, including using the FHA and Fannie Mae and Freddie Mac as sources for refinancing subprime mortgages in imminent or actual default.

Second, long term steps to fundamentally improve the functioning of the mortgage market. I will repeat a very simple but powerful proposal: a one-page mortgage disclosure which tells borrowers what they really need to know about their mortgage loan

in a clear and straightforward way. This will both better equip borrowers to protect themselves and make the mortgage market more efficient.

Subprime Mortgages as a Classic Boom and Bust

Needless to say, the unsustainable expansion of subprime mortgage credit and the great American house price inflation of the new 21st century are both over. Former enthusiasm at rising home ownership rates and financial innovation (now a little hard to remember) have been replaced by large financial losses, a credit market panic, layoffs, closing or bankruptcy of scores of subprime lenders, accelerating delinquencies and foreclosures, a deep recession in the homebuilding industry, tightening or disappearing liquidity, and of course, recriminations.

Typical estimates of the credit losses involved are about $100 billion. This does not count losses in market value of mortgage securities or the macroeconomic effects. Rising foreclosures are also an obvious social and political issue.

All these elements display the classic patterns of recurring credit overexpansions and their aftermath, as colorfully discussed by students of financial cycles like Charles Kindleberger, Walter Bagehot and Hyman Minsky. Such expansions are always based on optimism and the euphoric belief in the ever-rising price of some asset class—in this case, houses and condominiums. This appears to offer a surefire way for lenders, investors, borrowers and speculators to make money, and indeed they do, for a while. As long as prices always rise, everyone can be a winner.

A good example of such thinking was the 2005 book by an expert housing economist entitled, Are You Missing the Real Estate Boom? Why the Boom Will Not Bust and Why Property Values Will Continue to Climb Through the Rest of the Decade.

It is important to remember that the boom gets going because people experience financial success. Subprime borrowers could get loans to buy houses they would otherwise be unable to and then benefit from the subsequent price appreciation. A borrower who took out a very risky 100% LTV adjustable rate mortgage with a teaser rate to buy a house which subsequently appreciated 30% or 40%, now had substantial equity and a successful outcome as a result of taking risk.

This time, we had several years of remarkably rising house prices—the greatest house price inflation ever, according to Robert Shiller, who has certainly been insightful in this matter. The total value of residential real estate about doubled between 1999 and 2006, increasing by $10 trillion. The great price inflation stimulated the lenders, the investors, the borrowers and the speculators. If the price of an asset is always rising, the risk of loans seems less and less, even as the risk is in fact increasing, and more leverage always seems better.

Of course, we know what always happens next: the increased risk comes home to roost, prices fall, and there is a hangover of defaults, failures, dispossession of unwise or unlucky borrowers, revelations of fraud and swindles, and the search for the guilty. You would think we would learn, but we don't. Then come late-cycle political reactions.

With regard to the last point, since 1970 we have had the Emergency Home Finance Act of 1970, the Emergency Housing Act of 1975, the Emergency Housing Assistance Act of 1983, and the Emergency Housing Assistance Act of 1988. (I do not count the Hurricane Katrina Emergency Housing Act of 2005, a special case.) Kindleberger estimated that over the centuries, financial crises recur about once a decade on average, and so apparently do emergency housing acts. It seems probable to me that, given the current problems, this fall will bring an emergency housing act of 2007.

A year ago, it was common to say that while house prices would periodically fall on a regional basis, they could not on a national basis, because that had not happened in the large U.S. market since the Great Depression. Well, now house prices are falling on a national basis, as measured by the S&P/Case-Shiller national index.

House sales have dropped steeply, and for-sale inventories of new and existing houses and condominiums are high. At the same time, rising mortgage delinquencies and defaults, along with the collapse of funding through securitization, have caused lenders to drop subprime products or exit the business altogether and generally raise credit standards. This has sharply reduced mortgage credit availability and thus housing demand.

With excess supply and falling demand, it is not difficult to arrive at a forecast of further drops in house prices. The recent Goldman Sachs housing forecast, pointing out "substantial excess supply" and that "credit is being rationed," projects that average house prices will fall 7% a year through 2008. This is along with projected falling home sales and housing starts.

Professor Shiller has suggested that this cycle could see "more than a 15% real drop in national home price indicies." Certainly a return to long term trends in house values would imply a significant adjustment.

The June 30, 2007 National Delinquency Survey of the Mortgage Bankers Association reports a total of 1,090,300 seriously delinquent mortgages. Serious delinquency means loans 90 days or more past due plus loans in foreclosure. Of the total, 575,200 are subprime loans. Thus subprime mortgages, which represent about 14% of mortgage loans, are 53% of serious delinquencies.

The survey reports 618,900 loans in foreclosure, of which 342,500 or 55% are subprime.

The ratio of subprime loans in foreclosure peaked in 2002 at about 9%, compared to its current level of 5.5%. Seriously delinquent subprime loans peaked during 2002 at

11.9%, compared to the current 9.3%. These ratios at this point are not as bad as five years ago, but they are still rising.

A systematic regularity of mortgage finance is that adjustable rate loans have higher defaults and losses than fixed rate loans within each quality class.

We may array the June 30, 2007 serious delinquency ratios as follows:

| | | | |
|---|---|---|---|
| Prime fixed | 0.67% | Prime ARMs | 2.02% |
| FHA fixed | 4.76% | FHA ARMs | 6.95% |
| Subprime fixed | 5.84% | Subprime ARMs | 12.40% |

The particular problem of subprime ARMs leaps out of the numbers. Also notice that FHA and subprime serious delinquency ratios for fixed rate loans are not radically different. The FHA is predominately a fixed rate lender, whereas subprime is about 53% ARMs. The total range is remarkable: the subprime ARM serious delinquency ratio is over 18 times that of prime fixed rate loans.

A central problem is that during the boom the subprime market got very much larger than it used to be. In the years of credit overexpansion, it grew to $1.3 trillion in outstanding loans, up over 8 times from its $150 billion in 2000. So the financial and political impact of the subprime level of delinquency and foreclosure is much greater.

The scale of the whole market is impressive. American residential mortgage market is the biggest credit market in the world, with about $10 trillion in outstanding loans. Residential real estate is a huge asset class, with an aggregate value of about $21 trillion, and is of course the single largest component of the wealth of most households. A 15% average house price decline would mean a more than $3 trillion loss of wealth for U.S. households, which would be especially painful for those who are highly leveraged. It would certainly put a crimp in getting cash to spend through cash-out refinancing and home equity loans.

## Policy Responses

There are two categories of possible responses: temporary programs to bridge the bust, and fundamental, long term improvements.

### 1. Temporary Programs

The Federal Reserve and other central banks have already provided significant amount of liquidity support to the panicky international credit markets, which are suffering from not knowing who is in trouble from leveraged speculations in subprime securities and from great uncertainty about what such securities are worth. The Fed has lowered its target fed

funds rate. Lower short term rates make it cheaper to carry leveraged positions in securities unable to be sold at prices acceptable to the seller and help ease the panic.

In any case, panics are by nature temporary and the liquidity crisis won't last forever. Large losses will be taken, who is broke and who is solvent sorted out, risks reassessed, models rewritten, and revised clearing prices discovered. Market actors will get back into business trading with and lending to each other again. Liquidity will return for markets in prime instruments. An astute long-time observer of finance, Don Shackelford, has predicted that "the panic about credit markets will be a memory by Thanksgiving."

He may well be right; however, the severe problems with subprime mortgages and securities made out of them, related defaults and foreclosures, and falling house prices will continue long past then.

Falling house prices tend to cause higher mortgage defaults, especially if loans were made, as they were, with small or no down payments, and especially if a substantial proportion of loans were to speculative buyers, as they were. So the U.S. appears to risk a process in which defaults on mortgages, and securities made of mortgages, cause tightening credit (as well as houses dumped on the market through foreclosure), tight credit reduces demand, which induces falling house prices, which cause more defaults, more credit tightening, lower house prices…. In other words, there is risk of a self-reinforcing downward cycle, or debt deflation, in the housing sector.

To try to bridge the bust and ameliorate the downward cycle is a reasonable project with much historical precedent. History is clear that governments always intervene in some fashion.

But what fashion makes sense? Intervention should be temporary, inhibit as little as possible personal choice and the long run innovation and efficiency of the market, and should not bail out careless lenders and investors or speculative borrowers.

To help bridge the bust with an appropriate means of refinancing adjustable rate subprime mortgages is a project worth pursuing. A recent survey of mortgage brokers found that of home purchase closings they had scheduled for August, 2007, 56% of subprime homebuyers had canceled closings. Of subprime borrowers trying to refinance adjustable rate mortgages with resetting interest rates, the survey found that 64% of the subprime homeowners were unable to do so.

President Bush, numerous members of Congress, and the FHA itself have suggested using the FHA as the means to create a refinancing capability for subprime mortgages. This makes sense because the FHA itself is, and has been since its creation in 1934, a subprime mortgage lending institution. Of course, they didn't call it that, but historically if you couldn't qualify for a prime loan, you went to the FHA.

We noted above that the latest MBA survey shows that serious delinquencies for fixed rate FHA and subprime loans are similar. So are total past due loans: 14.54% of

subprime loans are past due, as are 12.40% of FHA loans. The difference is in the foreclosure inventory: although both are far over the prime foreclosure ratio of 0.59%, the 5.52% for subprime is two and a half times the 2.15% for the FHA. The FHA, being itself the principal credit risk taker, logically has more ability to practice forbearance and loss mitigation.

But with falling house prices, the amount the FHA could responsibly refinance is liable to be less than the outstanding principal owed on the subprime mortgage. Here the owners of these mortgages, typically investors in structured MBS issued by a securitization trust, need to take a loss for the difference. Investors in such speculative instruments should not be bailed out, and the loss in economic value has occurred already: it is a matter of its becoming a realized haircut.

Here we run up against the complications of the laws, regulations and contracts governing mortgages in securitized form and the duties of the agents for the investors. The mortgage servicers who actually deal with the borrower, but are not themselves the owner of the mortgage, have the ability as agent to make loan modifications for loans in default or imminent default. But the standard of their fiduciary duty is to maximize the returns to the bondholders of the securitized mortgage trust.

To accept less than full repayment in settlement of a troubled loan from the proceeds of an FHA refinancing, the mortgage servicer would have to be quite confident that this was a clearly better outcome for the bondholders than proceeding to foreclosure. Fortunately, from this particular point of view, foreclosure is an extremely expensive process for the investors.

Thus I believe that a special program in which the FHA could refinance 97% of the current value of the house, and the investors would accept a loss on any difference between that and the principal owed, would be an alternative distinctly preferable to foreclosure for the investors, as well as obviously so for the borrowers. This would allow the borrowers to go forward with a small positive equity in the property and a loan of more appropriate size. That such a program would be accompanied by risk-based FHA insurance premiums seems reasonable to me.

Putting this in the context of the evolution of the mortgage market, the Mortgage Bankers Association has reported that subprime mortgages grew from 2.4% to 13.7% of total mortgage loans between 2000 and 2006. But the proportion of prime loans also increased, from 72.6% to 76.6%. What went down? It was the market share of the government's FHA (and much smaller VA) programs, which fell from 25.2% to only 9.7%. The combined share of subprime plus FHA-VA stayed more or less the same, but within that, subprime took a lot of market share away from the government alternatives.

That was during the boom. Now in the bust, the FHA, the creation of the great bust of the 1930s, would take that market share back.

Let me turn to Fannie Mae and Freddie Mac.

Two proposals regarding Fannie and Freddie are relevant as temporary bridge programs: to increase their conforming loan limits and to relax their mortgage portfolio caps. Both of these represent great profit opportunities for Fannie and Freddie, and it is the fiduciary duty of their managements to their shareholders to push these ideas as strongly as possible.

I do not favor an increase in the conforming loan limit, because it would principally operate to expand the government's credit into the prime jumbo loan market and, as discussed above, I believe the markets for prime assets will fairly quickly recover from panic on their own.

Relaxing the portfolio caps is more interesting and capable of being focused on the key issue of refinancing subprime ARMs. As odd as it may seem coming from an AEI fellow, I do favor granting Fannie and Freddie a special increased mortgage portfolio authorization, strictly limited, however, to a segregated portfolio solely devoted to refinancing subprime ARMs. Such a special authorization might be for $100 billion each, and include the ability to purchase FHA-insured subprime ARM refinancings. FHA loans would then have both a Ginnie Mae and a Fannie-Freddie funding channel.

As a last point, actual purchase of subprime mortgages by a special government fund has sometimes been proposed. A very interesting historical example of such a program was the Home Owners' Loan Corporation, created by the Home Owners' Loan Act of 1933. The HOLA bought defaulted mortgages from lenders in exchange for its own bonds, but would refinance not more than 80% of what it considered the long term value of the property. It ended up purchasing 20% of all the mortgages in the nation, from which we can see that our problems, however serious, don't even begin to approach those of the 1930s.

## 2. A Simple Proposal for Fundamental Improvement of the Mortgage Market

The mortgage market, like all financial markets, is constantly experimenting with how much risk there should be, how risk is distributed, and how it trades off with financial success or failure.

Nothing is more apparent than that we want the long term growth, innovation and economic well being for ordinary people that only market experimentation can create, even though this involves boom and bust cycles which can be avoided only in hindsight.

Should ordinary people be free to take a risk in order to own a home, if they want to? Yes, provided they understand what they are getting into. (This is a pretty modest risk, to say the least, compared to those our immigrant and pioneer ancestors took!)

Should lenders be able to make risky loans to people with poor credit records, if they want to? Yes, provided they tell borrowers the truth about what the loan obligation involves in a straightforward, clear way.

A market economy based on voluntary exchange and contracts requires that the parties understand the contracts they are entering into. In particular, a good mortgage finance system requires that the borrowers understand how the loan will work and how much of their income it will demand.

It is utterly clear than that the current American mortgage system does not achieve this. Rather it provides an intimidating experience of being overwhelmed and befuddled by a huge stack of documents in confusing language and small type presented to us for signature at a mortgage closing. This complexity results from legal and compliance requirements; ironically, past regulatory attempts to insure full disclosure have made the problem worse. This is because they attempt full, rather than relevant, disclosure.

Trying to describe 100% of the details in legalese and bureaucratese results in essentially zero actual information transfer to the borrower. The FTC recently completed a very instructive study of standard mortgage loan disclosure documents, concluding that "both prime and subprime borrowers failed to understand key loan terms."

Among the remarkable specifics, they found that:

"About a third could not identify the interest rate"

"Half could not correctly identify the loan amount"

"Two-thirds did not recognize that they would be charged a prepayment penalty" and

"Nearly nine-tenths could not identify the total amount of up-front charges."

This is a fundamental failure of the American mortgage finance system. It is especially important in, though by no means limited to, the subprime mortgage market.

To have informed borrowers who can better protect themselves, the key information must be simply stated and clear, in regular-sized type, and presented from the perspective of what commitments the borrower is making and what that means relative to household income. The borrowers can then "underwrite themselves" for the loan. They have a natural incentive to do so—we need to ensure they have the relevant intelligible, practical information.

Disclosures should focus on the financial impact on the borrower, not the technical description of the mortgage loan. They should include the monthly cost of the loan payments, including principal, interest, taxes and insurance--both at the beginning rate and the fully-indexed rate-- and express this as a percentage of the borrower's household

income. That household income itself should be prominently confirmed. It is also essential clearly to disclose any prepayment penalties.

This can be done on one page. I propose, as I have in previous House testimony, a one-page form, "Basic Facts About Your Mortgage Loan," to do this. (The proposal also contains an attachment with brief explanations of the mortgage vocabulary and some avuncular advice for borrowers.) Borrowers should have to receive the completed form, signed by the lender, well before the closing.

A copy of the proposed form accompanies this testimony.

I appreciate very much, Ranking Member Bachus, that you and your co-sponsors included this proposal in HR 3012 and, Congressmen McHenry and Green, that you have announced you are working on a bill which would require the one-page disclosure.

I believe this requirement would help achieve the required clarity, make borrowers better able to protect themselves by understanding what the mortgage really means to them, and at the same time would promote a more efficient mortgage finance system. This seems to me a completely bipartisan idea, which should be implemented as a fundamental reform, whatever else is done or not done.

Thank you again for the opportunity to share these views.

Accompanying attachment: One-Page Form ("Basic Facts About Your Mortgage Loan")

# THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower: _____ Property address: _____

_____ _____

_____

Lender: _____

Amount of loan: $ _____, which is _____ % of the property's appraised value.

Your loan is for _____ years.

The type of loan you have: _____

Your beginning interest rate is_____ %. This rate is good for _____ months/years. The rate and your payment can go higher on _____ and each _____ months after that.

Today's estimate of how high the rate will go, called the fully indexed rate, is _____ %.

The maximum possible rate on your loan is _____%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF $ _____ .

Your beginning rate = a monthly loan payment of $_____ = _____ % of your income.

-including taxes and insurance this is about $_____ = _____ % of your income.

The fully-indexed rate = a loan payment of $_____ = _____ % of your income.

-including taxes and insurance this is about $_____ = _____ % of your income.*

*This is called your fully indexed housing expense ratio.

**Special factors you must be aware of:**

-A prepayment fee of _____ must be paid if_____ .

-A "balloon payment" of $ _____ to pay off your loan will be due on _____ .

-You do/do not have a "payment option" loan. If you do, make sure you really understand what this means.

Start with the definition on page 3.

Total "points" plus estimated other costs and fees due at closing are $ _____ .

FOR QUESTIONS CONTACT: Name: _____

Phone:_____ e-mail:_____

**See definitions of underlined terms and guidelines on pages 2–3.**

**DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!**

_____

Borrower Date

_____ _____

Authorized Signer of Lender Date Borrower Date

## The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

### Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. Especially if it is a low introductory or "teaser" rate, it is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate will go up by a lot. You need to know.

The *fully-indexed rate* is an essential indicator of what will happen to your interest rate and your monthly payments. It is today's estimate of how high the interest rate on an adjustable rate mortgage will go. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if your formula is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is 5% + 3% = 8%. At the time the loan is being made, the fully indexed rate will *always* be higher than a beginning "teaser" rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser" rate for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most

mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.

A "*balloon payment"* means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A "*payment option" loan* means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. This is called "negative amortization." The very low payments in early years create the risk of very large increases in your monthly payment later. Payment option loans are typically advertised using only the very low beginning or "teaser" required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? (4) What is the fully-indexed rate?

*"Points"* are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

*Closing* is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don't be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it.* You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don't pay. Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign.